

# Issue Paper

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## Ukraine and the Caspian An Opportunity for the United States

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The United States has said that the Caspian region, and the development of its energy resources, is a key national security interest. It has also made clear its commitment to the independence of Ukraine. But current options for Caspian oil transport are beset with political and logistical problems and, therefore, fall far short of guaranteeing the safe, secure export of Caspian oil in the short or long term. At the same time, Russia's increasing stranglehold on Ukraine's energy imports does not bode well for the smaller country's ability to maintain its hard-won sovereignty, and it increases the risk that Ukraine will call on the United States and its NATO allies to stand behind it against Russia. The development of an export route for Caspian oil through Ukraine is a cheap and effective means of ameliorating both problems, and thus an approach that Washington should support.

### CASPIAN OIL, THE UNITED STATES, AND UKRAINE

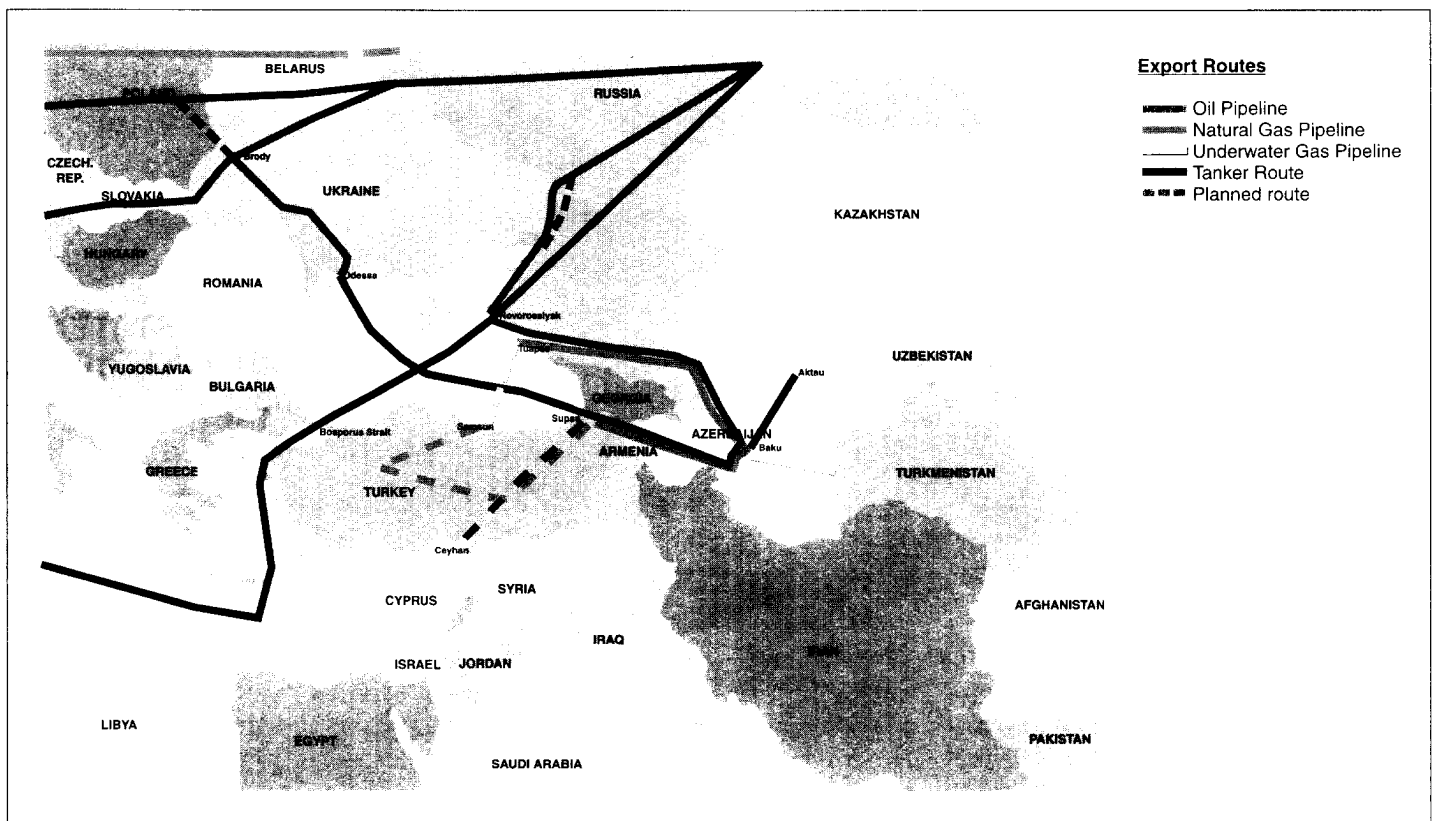
The Caspian Sea basin has attracted considerable attention in recent years, due largely to speculation as to the potential size of the region's natural gas and oil reserves. While analysts continue to debate whether the resources will ever prove truly significant, states are making policy choices in the apparent belief that they will. The United States is no exception. The potential for energy wealth has already led Clinton administration officials to class Central Asia and the Caucasus as a region "vital" to the United States.<sup>1</sup> Washington hopes that the development of natural gas and oil there will lead to reduced reliance

on Middle Eastern suppliers for both the United States and its European allies. It also sees successful exploitation as the key to independence and prosperity for the Caspian states. This independence and prosperity, it is believed, will in turn foster democracy, something Washington has long held as a central policy goal for all of the former Soviet Union.

Because the United States is far from alone in its interest in the region and its resources, however, there is plenty of room for discord. One of the primary points of contention has been the question of how Caspian oil and gas will reach customers. The easiest, most direct route is through Iran, but Washington has been vehement in its opposition to Teheran's involvement in Caspian development. Moscow advocates an expansion of current transport routes—through Russia and over the Black Sea (or, in the case of natural gas, under it). Ankara, while cooperating with Moscow to develop the underwater natural gas pipeline plan, is strongly opposed to its preferred oil route, citing the environmental hazards posed by increased traffic through Turkey's narrow Bosphorus Strait. Instead, Ankara supports the Baku-Ceyhan route through Azerbaijan, Georgia, and its own territory. While paying some lip service to the advantages of several alternative routes for Caspian oil, the United States has in fact also thrown its support entirely behind Baku-Ceyhan. This exclusivity on Washington's part is a mistake.

The Baku-Ceyhan route begins in Kazakhstan (see map on page 2). Already tankers ship oil from Kazakh ports to Baku, where it joins Azerbaijani oil in a journey along a newly refurbished pipeline to and through Georgia. Baku-Ceyhan's supporters hope to build an additional

<sup>1</sup>Federico Peña (U.S. Secretary of Energy), "U.S. Role in the Caucasus and Central Asia," testimony before House International Relations Committee, April 30, 1998.



pipeline from Georgia to Turkey, culminating in the Turkish port of Ceyhan. Such a route would have tremendous political advantages for its participants—and for the United States. It avoids both Iran and Armenia. It traverses Turkey, a longtime friend and NATO ally, as well as Georgia and Azerbaijan, key NATO Partnership for Peace states with which U.S. ties have been growing exponentially in recent years.

Analysis suggests, however, that constructing Baku-Ceyhan would take longer and cost more than just about any other potential export alternative—and probably more than most current estimates (now running at \$2.5 to \$4 billion). The route passes through particularly harsh terrain and unstable secession-minded regions in Turkey and Georgia. Both constructing the pipelines and ensuring their security once built therefore pose significant challenges. This leads not a few to conclude that Baku-Ceyhan will never be completed, or if it is, can never be fully successful or cost-effective. It is not surprising that investors have been wary. The November 1999 signing of the key package of agreements on Baku-Ceyhan was possible only because Turkey promised tax and tariff reductions for oil companies willing to invest and the United States offered political risk insurance to investors. Washington also provided a grant of \$823,000 to help finance pipeline construction in Turkey. Even then, the Azerbaijan International Operational Company

(AIOC), the consortium responsible for extraction on the Azerbaijani Caspian shelf, declined to participate.

The combination of these problems means that if the United States truly wants to ensure a safe and secure route for Caspian oil, it cannot look solely to Baku-Ceyhan. At the same time the very public nature of Washington's commitment to Turkey on this matter makes a reversal of policy impossible. What Washington really needs, then, is to put teeth into its claim that it supports alternative routes. It can do this most effectively by backing one or more "complements" to Baku-Ceyhan, short-term options for getting the oil to market while the Turkish pipeline is under construction, which would also provide a hedge against its failure.

Moscow would certainly like to see the United States drop its opposition to the route through Russia, but this option is even less tenable than Baku-Ceyhan. Not only is the strain on the Bosphorus already significant, but Caspian producers are loathe to give Russia full control over their exports. While there may be political reasons to include Russia in the Caspian energy boom—hopes of averting Moscow's likely anger at being excluded being paramount among them—the fact is that Russia will be involved with or without exporting other countries' oil. For one thing, it has Caspian oil reserves of its own. For another, its plans, in cooperation with Turkey, for natural

gas exports are more likely to go forward than any other option for that resource.

What else is on the table? The Iran route is anathema to the United States, and likely will remain so for some time. Even if it were not, it seems ill advised to ship oil billed as an alternative to reliance on the Middle East through one of the Middle East's largest oil producers. A proposal to ship the oil over the Black Sea to and through the Balkans seems equally imprudent, given the instability of that region.

Happily, there is another alternative. For years, Ukraine has advocated a route through Azerbaijan and Georgia, over the Black Sea, and through Ukraine to Poland. Although this proposal has been all but ignored in Washington, it has real potential. Most of the necessary pipeline already exists. Ukraine's ongoing improvements to its refinery and pipeline infrastructure, given some foreign assistance to speed the process, will make it sufficient both to handle the "early" oil, extracted in the next few years while Baku-Ceyhan is still building, and to process even larger quantities later. Perhaps most important, the price tag would be relatively small: the cost of a few miles of pipeline (estimated at \$400 million) and facility development and improvements (about \$600 million).

Why, then, has this option not been seriously considered to date? One reason is that despite Azerbaijani and Georgian support and Kazakhstan's ongoing export of oil to Ukraine along this same route, the United States' single-minded championing of Baku-Ceyhan has drawn investor attention away from this possibility. Ukraine's abysmal investment climate and lack of energy sector reform have not helped either. Current tax laws penalize rather than invite foreign investors. Ukraine's energy sector is among the least efficient in the world. But if U.S. support for a Ukrainian pipeline option is linked to progress in these areas, the climate for change now is better than ever before. This is because Ukraine today has the most reform-minded government it has had in years. Furthermore, Ukraine has an additional incentive: if it is to hold on to its independence, it needs this route for Caspian oil to begin development—and soon. And the fact of the matter is, the United States needs Ukraine to hold on to its independence.

## THE LINK TO UKRAINIAN SOVEREIGNTY AND WHY IT MATTERS TO THE UNITED STATES

Over the course of the 1990s, U.S. policy toward Ukraine underwent a significant transformation. Washington's initial interest was narrow: to make sure Ukraine fulfilled its commitment to become a non-nuclear weapons state. But with that goal accomplished in 1996, the relationship has continued to grow and expand into what is today a close and substantive friendship to which the United States has devoted considerable resources. Recently, U.S. Secretary of State Madeleine Albright identified Ukraine as one of four countries deserving of Washington's particular notice and assistance, promising to help sustain this "partner and friend[s]" democratic path.<sup>2</sup>

To Ukraine, its ties with the U.S. are its last and best guarantee of security and sovereignty. For centuries, Ukraine has been integral to Russia's empires, both Soviet and Czarist.<sup>3</sup> To many, if not most, Russians, the notion of an independent Ukraine remains a rather alien concept at best. Thus, this country's short history of independence has been shadowed by fears that Russia would eventually reassert control. And, in fact, while official Russian attitudes toward Ukraine have mellowed from the days when Russian officials dismissed Ukraine's independence as "transitional," Moscow retains its goal of greater integration among all the former Soviet states and looks askance at its neighbors' development of closer ties with the United States and the West, which Russia increasingly sees as threatening. In Ukraine's case, this is particularly significant. Of all of the post-Soviet states, it has been most active in courting U.S. friendship.

It is in part to avoid angering Russia that the United States (and NATO and its other members) has steered clear of granting Ukraine any firm security commitments. Instead, the suggestion of alignment was proffered through NATO's Partnership for Peace (PFP) program and continuing bilateral military-to-military ties. As a result, Ukraine has little to rely on other than the hope that NATO and/or the United States will protect it if Russia makes a hostile move. As long as Moscow maintains its official policy of supporting Ukrainian sovereignty, of course, this is not a problem. But a hardening of Russia's stance towards Ukraine could set off a dangerous chain reaction. A threatened Ukraine would have little

<sup>2</sup>Barry Schweid, "U.S. Turns Attention to 4 Countries," *Associated Press*, January 18, 2000.

<sup>3</sup>On Russia's view of itself/its empire and Ukraine's role, see Roman Solchanyk, "Ukraine, the (Former) Center, Russia, and 'Russia,'" *Studies in Comparative Communism*, Vol. 25, No. 1, March 1992, pp. 31-45;

Roman Solchanyk, "Russia, Ukraine, and the Imperial Legacy," *Post-Soviet Affairs*, Vol. 9, No. 4, 1993, pp. 337-365; and Roman Szporluk, "The Fall of the Tsarist Empire and the USSR: The Russian Question and Imperial Overextension," in Karen Dawisha and Bruce Parrott, eds., *The End of Empire? The Transformation of the USSR in Comparative Perspective*,

choice but to ask for Western assistance. This would not only anger Russia, exacerbating the situation, but would force an unwelcome choice for Brussels and Washington. For the United States and NATO, giving Ukraine the support it desires would invite conflict with Russia. But failing to do so would not only mean the end of Ukraine's independence, but would also send a frightening message to all of their other "Partners" and friends about the credibility of that friendship.

Certainly the best outcome for all concerned is to prevent such an eventuality by taking steps to ensure that Ukraine's sovereignty is guaranteed by more than a vague hope of Western support. But Russia's ability to pressure Ukraine effectively is increasing, for in recent months Russia has begun to shift the power balance between the two states in the single most important sector of their interaction: energy imports and exports.

Ukraine, like most other post-Soviet states, remains highly dependent on Russia for its energy. This includes the vast majority of its natural gas, of which Ukraine is one of the world's largest consumers, and its oil. Furthermore, Ukraine's nuclear sector is dependent on Russia both for provision of fuel rods for its nuclear power plants and for reprocessing of waste.

Russia has repeatedly used the energy advantage to pressure its neighbors toward greater alignment. But despite its dependence on Russian energy and its huge debt to Moscow (estimated at between \$740 million and \$2.8 billion), Ukraine, unlike other post-Soviet states, has been able to resist Russia's efforts to transform energy dependence into policy influence. Despite Russia's steps to raise tariffs, force Ukraine to swap debt for equity, and occasionally cut off fuel entirely, Kyiv's policy has over time become more, not less, Western in orientation.

Ukraine has been able to do this because it has a counter-lever. Even as it receives most of its energy resources from Russia, most Russian exports of natural gas and oil must travel through pipelines on Ukrainian soil. It is only in this way that they can reach paying, reliable customers in Western and Eastern Europe. As a result, Kyiv can respond to pressure by shutting down a significant part of Russia's European exports. When it has done so, both Russia and the Europeans have been angered, but Moscow has backed down, as it did in 1997 when it agreed to higher transit costs across Ukraine. Furthermore, Moscow is effectively prevented from cutting off Ukraine's fuel for any significant length of time, because this also cuts off fuel to its Western customers.

Both countries are thus trapped in a mutually harmful relationship by a self-propagating system of counter-productive incentives. Moscow's hope that Ukraine's dependence will translate into closer policy alignment between the two countries keeps the natural gas and oil flowing. Such increased cooperation has not emerged, however, because Ukraine controls Russia's export routes. For this same reason, Moscow cannot even punish Kyiv by turning its back. To the contrary, it is forced to be unusually lenient—repeatedly restructuring Ukraine's mounting debt. This continuing provision of natural gas and oil from Russia, accompanied by lenient debt terms, in turn creates disincentives for Ukraine to look too hard for alternatives, or to make the difficult domestic choices that would foster more-efficient use of energy resources and thus a lessening of debt and dependence.

Now, however, this situation is changing, as Russia has begun to minimize its dependence on Ukrainian energy routes. The most important of these to date is the increasingly misnamed Yamal-Europe pipeline, initially conceived to transport natural gas from Russia's northern Yamal fields through Belarus and Poland to Western markets. While the planned pipeline to Yamal is far from complete, the European sections should be finished sometime in 2000, enabling a significant portion of Russian natural gas exports to Europe to be diverted around Ukraine.

Similarly, according to plans approved in 1999, a new pipeline will be built to bypass the current route that Russian oil takes through eastern Ukraine, an idea first broached in 1996–1997. This will eliminate what to Moscow are unnecessary transit payments for oil that then returns to Russia for its journey to Russia's Novorossiisk port and refinery. It will also divert some of the oil that might otherwise go to similar facilities in Ukrainian Odessa. Finally, Russia's planned Baltic Pipeline System (now under construction) will not only avoid the Baltic States, through which many of Russia's other oil exports now transit, but will provide another alternative to routes through Ukraine.

These new pipelines, especially Yamal-Europe, will significantly diminish the leverage Ukraine has enjoyed over Russia's exports, and will bolster Moscow's ability to influence Ukrainian policy choices. This is evidenced by Russia's recent harder line toward Ukraine, and Ukraine's submission to it. As winter chills set in at the end of 1999, spats between Moscow and Kyiv over tariffs, transit fees, and illegal diversion of resources escalated into what Ukrainian president Leonid Kuchma described as an "economic war." Even more significant, Ukrainian officials backed down, admitting to a higher level of debt

<sup>4</sup>Natal'chenko, "Russia Has Retrained Ukraine," *UAToday*, URL <http://www.uatoday.net/kernel/economy/news.518>, January 18, 2000.

and to unauthorized diversion of gas. In Russia, this was seen as a direct result of Moscow's policy of energy cut-offs and pipeline bypass plans—the successful “retraining” of Ukraine.<sup>4</sup>

In theory, Ukraine has two options for withstanding Russian pressure. One is to convince NATO or the United States to put its military weight behind Ukraine as a counterpoint to Russian pressure. This is, however, an unfortunate option from all perspectives. Ukraine's active courting of Western help will anger Russia further, possibly escalating the situation. If Washington and Brussels get involved, they will be dragged toward an unwelcome confrontation with Moscow. If they do not, Kyiv will likely fall to Russian pressure.

Ukraine's other option is to reduce its energy reliance on Russia, and quickly. But this poses its own problems. While Ukraine has potentially large domestic reserves of oil and gas, their exploitation would require considerable foreign investment. Although interest has been expressed by a number of companies, most notably British Petroleum, Ukraine's aforementioned legal and tax framework has continued to repel investors. Furthermore, even if efforts to reform the investment climate were successful, the prospects for exploiting Ukraine's oil and gas wealth are strictly long-term, a question of several years at least.

Ukraine's coal sector was long a primary source of energy for this country—nearly half of its domestic energy production. Unfortunately, today the coal industry is a liability rather than an asset. Grossly inefficient methods of production have significantly contributed to the overall energy arrears problem. Miners often go unpaid for months at a time. But fixing the coal sector to make it work at all better would be overwhelmingly expensive. Interestingly, however, there are believed to be significant gas reserves in the Donbass, the very region where Ukraine's ailing coal sector is centralized. If the tax and investment laws were to be fixed, then, the development of Ukraine's domestic gas production could serve to revitalize the area.

Ukrainian officials have long looked to nuclear power as the solution to the energy-dependence problem. As early as 1991, Goskomatom, Ukraine's state atomic energy company, invited bids on establishing a joint fuel production enterprise, which would eliminate Ukrainian dependence on Russian fuel rods. But the contest was won by a Russian firm, somewhat defeating the purpose. More recently, the United States has offered assistance, and Westinghouse has been contracted to fabricate VVER-1000 fuel rods for Ukraine.

Even if Ukraine can make its own fuel rods, however, it must still ship the spent fuel to Russia, to waste processing facilities in Krasnoyarsk. Furthermore, Ukraine's nuclear sector as a whole suffers from underfunding, inefficiency, and safety concerns. Ukraine has hoped to use foreign assistance, promised by European lenders and the G-7 in connection with the decommissioning of reactors at the infamous Chornobyl nuclear power plant, to build new facilities. Unfortunately, foreign funders are unconvinced that Ukraine needs new nuclear power plants and have been hesitant to invest in an industry that they see as a hazard.

Last but not least, the fact remains that what Ukraine's energy sector needs most is internal reform. This includes not only revisions to investment and tax laws, but also significant changes in how energy is allocated, purchased, and paid for at all levels, including both households and industry. The growth of the barter system and debt arrears at the local level have fed Ukraine's huge debt to Russia, increasing incentives to continue to “purchase” energy from that country. But the political difficulties of implementing effective reform mean that Ukraine also needs some strong incentives to take the necessary steps. To an extent, a harsher policy on the part of Moscow could serve this purpose, but the additional costs of increased subjugation to the Kremlin would limit the political benefits for Kyiv. A better option, then, is to find other suppliers, who would be less lenient than Russia, helping to spur reform, but with whom deals could be struck to provide Ukraine with some support during the transition process.

This brings us back, of course, to the possibility of a Ukrainian route for Caspian oil. Insofar as Kyiv can trade transit of energy exports from those states through its territory for some fuel for itself, while still having to purchase the balance, this could be a real opportunity to break the cycle of dependence with Russia—and to create incentives for reform. The Caspian states, particularly Azerbaijan, are ideal partners. These states need non-Russian routes for their oil for the same reasons that Ukraine needs non-Russian sources of energy: to break the cycles of dependence with Russia. Furthermore, Ukraine's involvement with Azerbaijan and Georgia (with Moldova and Uzbekistan) in the GUUAM grouping has paved the way for excellent relations. In fact, as already noted, both Georgia and Azerbaijan have repeatedly spoken favorably of a Ukrainian export route option.

What has kept it from happening is the lack of strong support from the West. But as has been demonstrated here, such support would clearly be in Washington's

interests. To recap, the Ukrainian export route will provide a secure and reliable complement to Baku-Ceyhan for Caspian oil export, one that does not require the United States to abrogate its commitment to Turkey, but which nonetheless serves as an excellent hedge should Baku-Ceyhan fail. It will also strengthen Ukraine from a security standpoint, enabling it to better withstand Russian pressure and, thus, significantly decrease the likelihood that it will ask the United States and NATO to defend it from its large neighbor. Furthermore, in diversifying Ukrainian energy imports away from Russia, this policy solution creates significant incentives for domestic energy sector reform as well as reform of the overall investment climate, which, in turn, should lead to development of Ukraine's own oil and gas resources.

Even if Baku-Ceyhan turns out to be successful, but Caspian resources are not as great as hoped, this option remains feasible. Because the Ukrainian route is also the short-term solution while Baku-Ceyhan is in the building, by the time such an eventuality comes to pass, Ukraine will have already reaped the security benefits of increased diversification, at little cost to investors. In fact, the refineries and pipeline built in support of this policy would be equally useful for bringing to market Ukraine's own oil, whose production will have been enabled by the improved investment climate. This will be invaluable in helping to ensure that Russia's ability to pressure Ukraine does not reemerge.

The United States has considerable leeway in the form that its support for a Ukrainian route for Caspian oil can take. Even simple statements of support from top policymakers would raise the profile of this alternative and thus generate industry interest in moving the refinery and pipeline projects forward. Even more helpful would be a package of incentives for industry of the sort offered for Baku-Ceyhan, even if on a far smaller scale. Since a key component of making the option truly feasible is reform of

Ukraine's investment climate (and its energy sector more broadly), U.S. help must be made contingent on such reforms, and assistance with the reform process, already ongoing, should be intensified.

The time to move forward on this is now. Russia's increased pressure combines with a new Ukrainian government, under Prime Minister Viktor Yushchenko, that is truly dedicated to reform. Since taking office, Yushchenko has pledged that energy reform will be a focal point of government efforts for the first quarter of 2000. Julia Timoshenko, a former head of one of Ukraine's largest gas companies, has been named First Deputy Prime Minister, with special responsibilities for the national fuel and energy complex. She, too, appears to be a dedicated reformer. The efforts of these executive branch officials have also recently been bolstered by parliamentary actions, such as the March 2000 vote to allow the privatization of natural gas pipelines.

In the long run, it is this sort of reform that will truly make Ukraine a viable and secure state. The elimination of debt arrears and the restructuring of all aspects of the energy sector such that they become appealing to investors will enable Ukraine's own gas and oil production to take off. This, combined with more efficient use of resources, is what will make long-term independence from Russia possible. In the short term, however, Ukraine is in desperate need of a way to diminish Russia's increasing leverage. If no cure is forthcoming for the disease, Ukraine will almost certainly seek to treat the symptoms, asking the United States and its other Western friends for increased and more concrete security commitments. In order to avoid the painful and potentially dangerous decisions that would force, the United States should move now to help Ukraine diversify away from Russian energy. Because it could also enable Washington to help to provide a more secure and reliable route for Caspian oil, this policy is particularly advantageous.

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